STATE OF CALIFORNIA

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Re: Possessory Interest Lease Modification and Corporate Reorganization of Lessee - Change in Ownership R&T Code Sec. 61(b).

Dear Mr. :

This is in response to your January 28, 1997 letter with enclosures, in which you request our opinion as to whether there would be changes in ownership and reappraisal of possessory interests as the result of certain modifications to the leases between , .(Partnership)and the Port District (Port District), a public agency whose property is exempt from property taxes. Enclosed with your request are the existing leases as amended for purposes of our review and a description of the following facts:

1. Taxpayer/lessee, (Partnership), entered into two separate leases from a public agency/lessor, the Port District, whose property is exempt from property taxes, in order to operate the Hotel and Marina, under the West Tower Lease effective in 1968 and the East Tower Lease, effective in 1969. Over the intervening years, the leases were amended several times with respect to the provisions for rent, insurance, default, encumbrances, etc., and in 1992, the assessor reappraised the possessory interests due to assignments of the leases.

2. Both leases provide for the payment of rent in the form of a percentage of the gross income, subject to annual minimum rents of $1,106,000 for the East Tower and $516,000 for the West Tower. The remaining current term under each lease as amended is approximately 33 years for the East Tower and 32 years for the West Tower. The leases will be modified as to their format, the amount of the minimum annual rent, and the conditions governing an assignment or encumbrance, and will include the addition of an option to extend the term.

3. Partnership, currently organized as a general partnership, is owned 50% by California Corporation (SC Corp) and 50% by Corporation (SHI Corp), both of which are wholly owned subsidiaries of Corporation (I Corp). Partnership was formed in 1992 as the result of a buy-outs of ., the lessee under all leases between 1983 and 1992,

which buy-outs triggered the changes in ownership at that time.[1] I Corp and its subsidiaries now propose an Internal Revenue Code Section 368(a)(1)(A) reorganization, based on the fact that they are members of the same affiliated group within the meaning of Internal Revenue Code Section 1504 and file a consolidated tax return under I Corp. In the reorganization, the two corporations will merge into their common parent I Corp, and I Corp will be named as the lessee in the modified leases.

You wish to know whether the proposed modified leases, including the rewriting of the current leases into a new format as well as the granting of options to extend the terms of the leases, will constitute changes in ownership of the possessory interests. Further, you wish to know whether the corporate merger and substitution of the parent I Corp as the lessee will constitute assignments of the leases and changes in ownership. For the reasons hereinafter explained, we believe that they do not. However, any conclusion reached is always a question of fact based upon the information available at the time. As we have not been provided with the modified leases or with the language in the modified leases, our analysis is limited to the conditions expressed in the existing leases and your description of the provisions in the modified leases.

1. Would the proposed modifications to the Leases, including the restatement into a new format, constitute changes in ownership of the taxable possessory interests?

No.

As you are aware, the creation, renewal, extension, or assignment of a possessory interest in any property is a change in ownership under Revenue and Taxation Code[2] section 61(b), and Property Tax Rules (18 California Code of Regulations) 462.080 and 467. In regard to the creation of a leasehold estate in taxable real property, Section 61(c)(1) is based on the premise that the language of any lease agreement creates (and terminates) the leasehold interests, establishing for assessment purposes who the primary owner of the property is. Therefore, substantial modifications to any lease agreement may constitute a "termination" of the existing leasehold and the "creation" of a new leasehold, if the modifications, taken as a whole, are materially different from those set forth in the existing leases. (See Lambert Letters 5/10/89 and 9/26/90, attached.) Since Section 61(b) states that the "creation" of a possessory interest is a change in ownership, as with creation of leasehold estates, determining the creation of possessory interests depends on the factual circumstances and the language in the lease agreements. In our view, based on the information submitted to us, the proposed modifications will not terminate the existing leases nor create new possessory interests, however, several changes will occur.

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[1] was a joint venture formed in 1983, composed of Life Insurance, holding 50% of the interests, SHI Corp holding 25%, and SC Corp holding 25%. was the lessee under the possessory interest leases between 1983 and 1992. In 1992, SHI Corp and SC Corp purchased 's 50% interest in , resulting in a change in control (per Section 64(c)) of , (since SHI Corp and SC Corp were wholly owned subsidiaries of I Corp), triggering the reappraisal of the possessory interest. Although dissolved and SHI Corp and SC Corp recorded a statement of partnership forming the current ., the leases were not amended to reflect this change.

[2] All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

First, the existing leases will be rewritten in a format similar to that currently utilized by the Port District. Thus, the modified leases will have a different form than the original leases, however, the terms and conditions will be essentially the same. Although we have not been provided with the modified leases, we have historically taken the position that reformatting is an example of a modification that does not involve a material difference in lease agreements. The critical factor is that the terms and conditions of the agreements between the parties remain substantially the same. In our view, the facts that a new format is used, obsolete words or phrases are removed (including the removal of and the substitution of I Corp as the lessees), and/or that the original lease agreements, presently contained in numerous documents (six lease amendments in the East Tower Lease and three lease amendments in the West Tower Lease) will be restated in a single document, do not result in changes in ownership if the leases are not terminated. (See also Eisenlauer Letter, 11/18/85, attached.) The only apparent substantive modification would be the deletion of and the substitution of I Corp, which was already determined to be the basis of the changes in ownership in 1992. Reforming the leases at this time to reflect the 1992 transfers is merely for the purpose of perfecting title to the possessory interest. (See Rule 462.240.)

Secondly, the minimum annual rent provisions in the leases will be changed, although the actual percentage rent will not be changed. The present minimum annual rent of $1,106,000 under the existing East Tower Lease will be changed to an amount which is equal to 75% of either the percentage rent payable during the past 12 months ($1,792,000), or subject to negotiation, 75% of the minimum annual rent paid over the past three years ($1,500,000). The present minimum annual rent of $516,000 for the West Tower Lease will, subject to the same negotiations, be increased to either $570,000, or will remain unchanged as determined by the three year average. The "Rental" provisions in the original leases contain schedules which are divided into two paragraphs, one stating the minimum annual rent and one stating the percentage rent per month. The modification suggested would substantially change the amount of the minimum annual rent required under the first paragraph.

Because the basic requirement for an annual minimum rent is same, and the payment schedule will be fundamentally the same, the variation in the amount does not appear to be a material difference. Unless the degree of variation was so substantial as to effect an entirely new agreement between the parties, we do not believe this modification to be material. We note further that the October 20, 1988 amendment to the East Tower Lease deleted the entire paragraph on percentage rent per month and substituted a new paragraph with different percentage amounts although the language was similar. No documents have been provided indicating that the assessor treated this modification as a renewal or as the creation of a new possessory interest.

Thirdly, the criteria and conditions governing the assignment of the leases and the encumbrance of the leasehold estate will be modified in order to reflect the Port District's policies. In the original leases, each of these provisions are lengthy and were apparently already amended at least once. In each amendment, however, the basic grant of authority from the Port District to the Lessee to assign the leasehold and to encumber the leasehold estate and improvements remained the same, and only some of the conditions changed. You have not

submitted the specific language to be used in accomplishing these proposed modifications. However, from the standpoint of general principle, we believe that if the fundamental points of agreement between the lessee and the Port District on these matters remain the same, and there are no major changes to the original provisions in this regard, then the modified leases will not terminate the existing leases nor result in the renewal of or in the creation of a new possessory interest.

2. Would the proposal granting an option to extend the terms of the leases constitute changes in ownership of the taxable possessory interests?

No.

Rule 467 states that "Possessory interests renewed, extended, subleased or assigned for any term shall be assigned at their full value as of the date of the renewal, extension, or as of the date the sub-lessee or assignee obtains the right to occupancy or use of the property." With respect to whether a "renewal or extension" of a possessory interest has occurred under Section 61(b), Property Tax Rule 21 states:

> The following definitions govern the construction of the words in the rules pertaining to possessory interests.
> . . .
> (h) "Extended or renewed" means the lengthening of the term of possession of an agreement by mutual consent or by the exercise of an option by either party to the agreement. (emphasis added)

In applying these provisions to these circumstances, you have stated that the proposal is simply to add an option to extend the term of each of the original leases. The original lease for the East Tower is for a term of 60 years, commencing August 1, 1969, and ending on July 31, 2029. The original term for the West Tower Lease is also 60 years, beginning on May 1, 1968, and ending on April 30, 2028. The original leases do not contain any options for extending the terms beyond these dates. The new modifications will provide an option to extend the term for approximately 27 years longer under the East Tower Lease and approximately 28 years with respect to the West Tower Lease. You have stated that each option would be exercisable only at the end of the current lease terms, 32 or 33 years from the present.

Based on the language in Rule 21(h), extending or renewing means either lengthening the term of the lease by express agreement or by the exercise of an option by either party. The reason behind this is that for change in ownership purposes, a new possessory interest is created whenever the term of the lessee's possession is actually extended (as distinguished from the "automatic" 35-year change in ownership standard for leases of taxable property). Merely adding the grant of an option to either party does not constitute the exercise of the option nor the "renewal" of a taxable possessory interest within the meaning of Section 61(b), since the option confers no possessory right created in the lessee.

Thus, when either option is actually exercised, 33 years from now in the case of the East Tower and 32 years from now in the case of the West Tower, the term of the lease which would have expired had the option not been exercised will be lengthened, constituting a renewal or extension and change in ownership of the taxable possessory interest at that time. (See also *Wrather Port Properties, Ltd. v. County of Los Angeles* (1989) 209 Cal.App.3d 517. See Eisenlauer Letter 2/28/91, attached, in which no "renewal" of the possessory interest occurred when the taxpayer was granted two additional five-year options to renew, but did occur when the options were exercised.)

3. Will the corporate merger and substitution of the parent corporation as the Lessee constitute assignments and changes in ownership of the possessory interests?

No.

The proposed reorganization involving a merger of SC Corp and SHI Corp into the parent corporation, I Corp, will result in a further modification of the existing leases, in that I Corp, rather than Partnership, will become the Lessee. As such, the question is whether this substitution constitutes an "assignment" of the taxable possessory interest within the meaning of Section 61(b). An "assignment" of a lease creating a taxable possessory interest is a transfer of the beneficial interest to another lessee which constitutes a change in ownership. (Rule 462.080.)

There is no change in ownership in the instant case primarily because of the 1992 buy-outs and changes in control of , in which the assessor already identified I Corp as the primary owner (lessee) of the possessory interests. In determining that there were changes in control, the assessor apparently became aware that I Corp was the "parent" of its two subsidiaries (SHI Corp and SC Corp), which purchased 's 50% interest in , the lessee. Thus, I Corp indirectly owned 100% of SHI Corp and SC Corp, which formed Partnership (the new lessee), effectively creating an "assignment" of the lease from to I Corp at that time. The assessor correctly treated this assignment as a change in ownership of the possessory interests and reappraised the properties. In our view, the proposed reorganization of Partnership and the two subsidiaries into I Corp does not alter I Corps "ownership" interests, and does not result in any assignment to a new entity.

Since the assessor apparently treats I Corp as the assessee per the 1992 change in ownership, the proposed reorganization and assignment to I Corp will simply perfect I Corp's existing title to the possessory interest per Rule 462.240(a)(1).

The views expressed in this letter are, of course, advisory only and are not binding on the assessor.

Our intention is to provide courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this goal are appreciated.

Very truly yours,

/s/ Kristine Cazadd

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